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## Near East and South Asia Review

21 April 1989

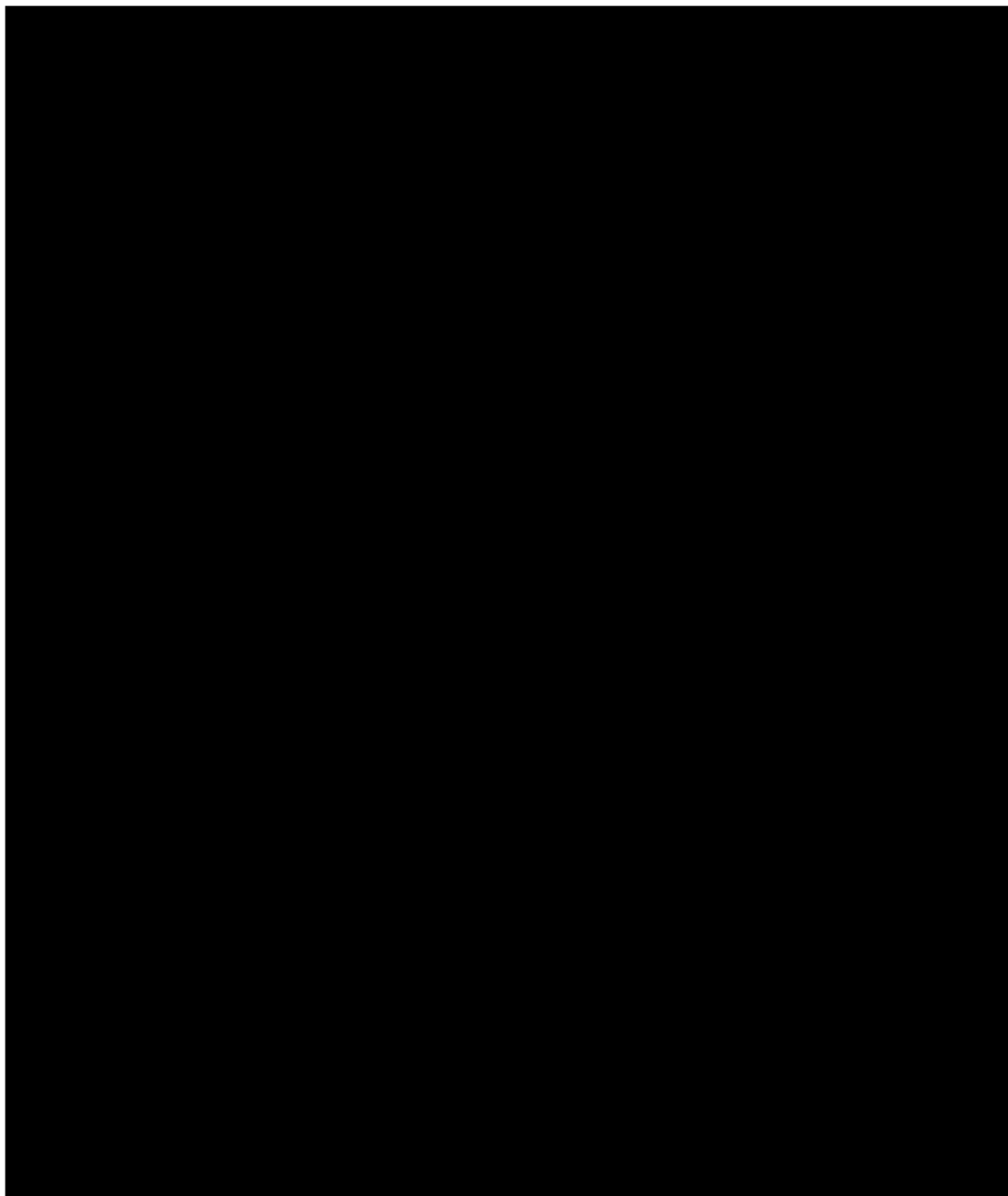
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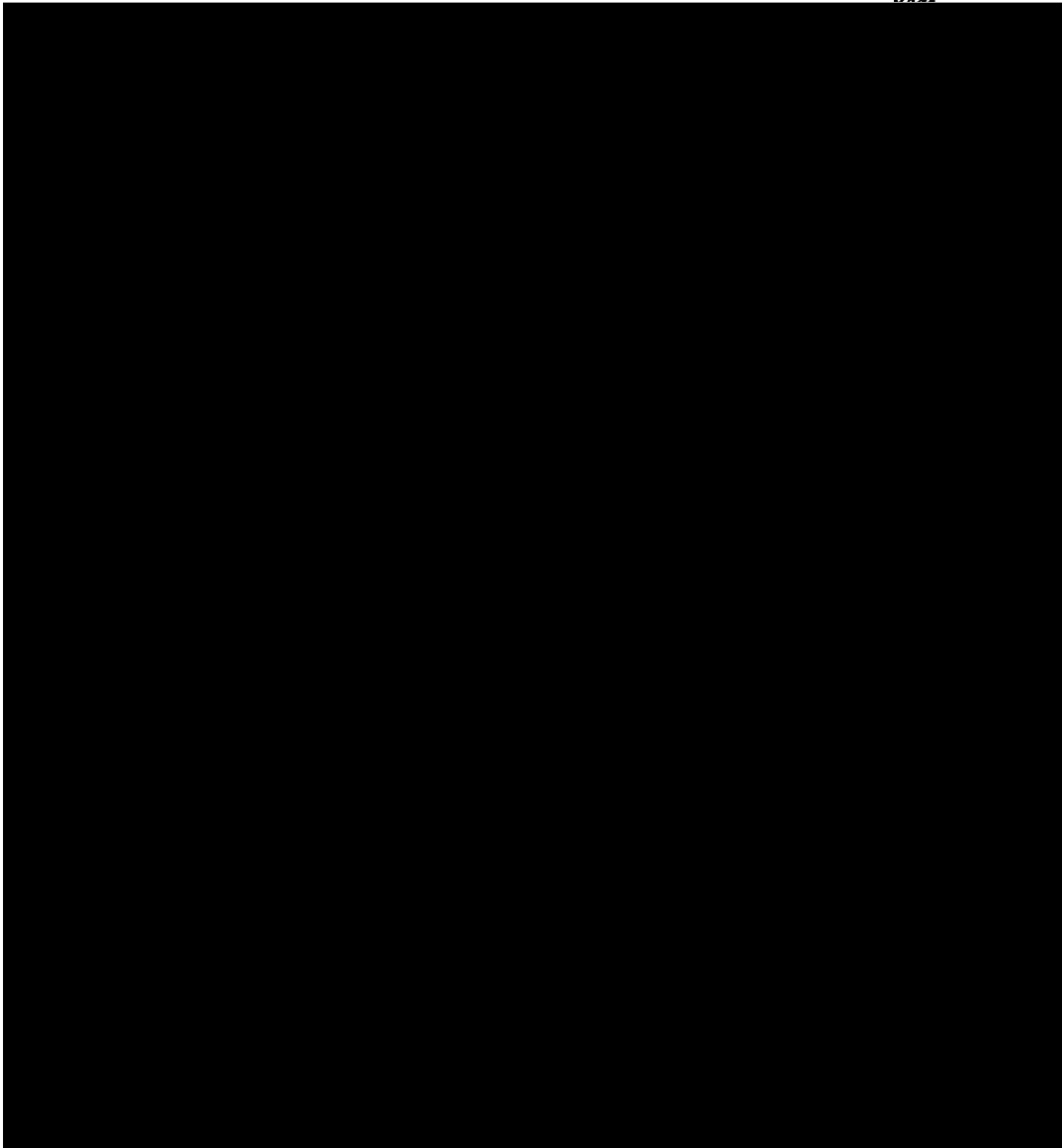


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**Near East and  
South Asia Review** ■

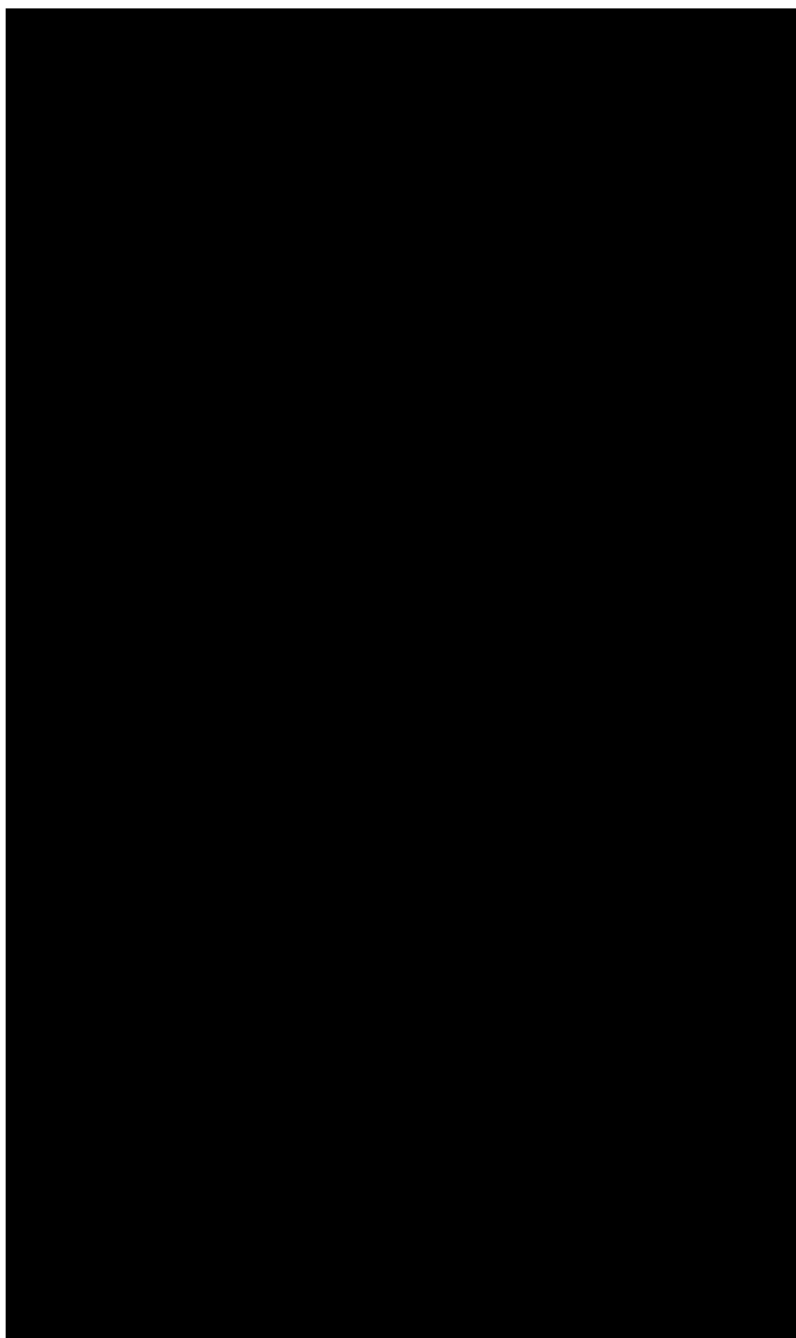
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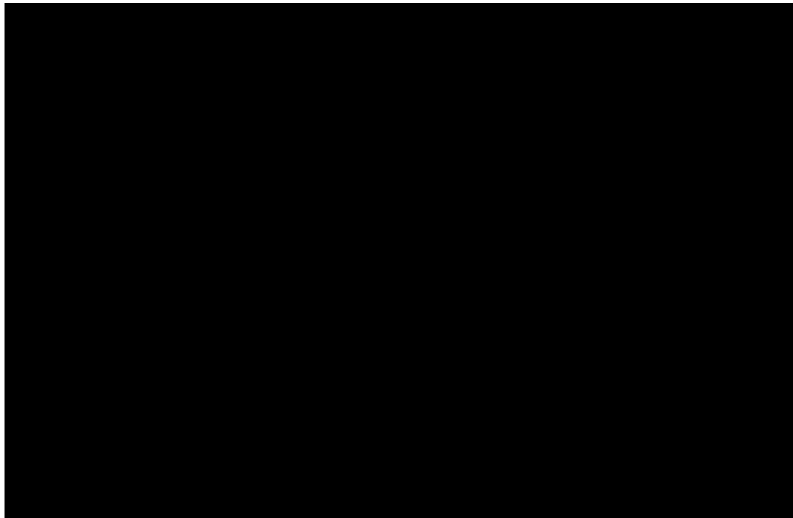


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**Nepal-India: The Economics of Deteriorating Relations**

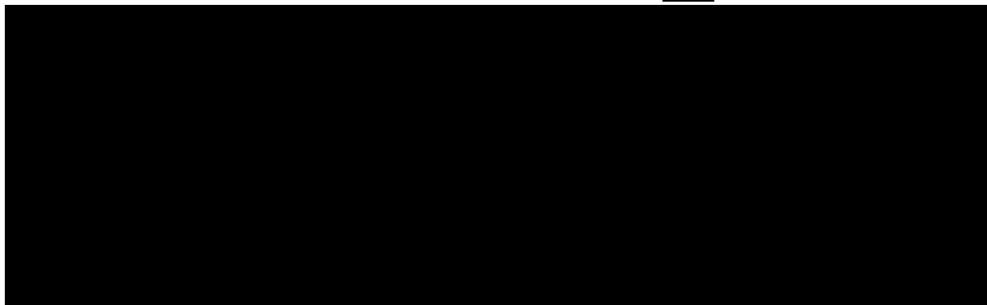
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Since the expiration on 23 March of the treaties that govern trade and transit between India and Nepal, Nepal's economic situation has deteriorated. Nepalese business and industry are suffering because of petroleum shortages and a cutoff of imports originating in India.

**Nepal: Resisting the Forces of Change**

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Despite decades of exposure to outside influences, Nepal remains a largely feudalistic society ruled by a virtually absolute monarch. Forces pressing for change are weak and divided, and King Birendra is not likely to espouse reforms that would establish a meaningful representative government any time soon.



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## Nepal-India: The Economics of Deteriorating Relations

Since the expiration on 23 March of the two major treaties that govern trade and transit between India and Nepal, Nepal's economic situation has deteriorated. India has allowed only two of the 15 border crossing points, vital links in the transit of goods to and from Nepal, to remain open. Goods from third countries are only trickling across the border because of administrative snags. Nepalese business and industry is on a downturn because of worsening petroleum shortages and a cutoff of imports originating in India. Prices have started to rise as the Nepalese begin hoarding in anticipation of future shortages. What are major inconveniences now could turn into severe hardships if the impasse does not end soon.

Nepal's desire to assert its independence and sovereignty and India's unhappiness with what it sees as Nepal's "anti-Indian" policies over the past two years have disturbed relations between the two countries to the point where they have been unable to work out new trade and transit treaties. India has been angry over Kathmandu's imposition of work permits on the 150,000 Indians living in Nepal, its efforts to give preferential treatment to Chinese commercial products and to award China a major roadbuilding contract near the Indian border, and its purchase of Chinese arms last year. In addition, New Delhi has been annoyed with Nepal's continued lobbying for its Zone of Peace proposal. Nepal, for its part, wants to break free of Indian dominance—publicly implying its desire to end its special relationship with India. Without the treaties, Nepal's trade with India is based on a most favored nation relationship—putting Nepal on the same footing as any other country. For Nepal, this means much higher costs, which are putting a strain on its economy.

The two countries will eventually have to work out new agreements. Kathmandu cannot hold out for long because of its deteriorating economic situation, which has already sparked internal unrest. New Delhi does

not want to be seen as the bully of South Asia, nor does it want Nepal to move from India's security sphere toward China. Although Nepal may eventually become more self-sufficient in trade, it will always depend on India for access to the port of Calcutta and for routes to the Nepal-India border.

### The Bilateral Economic Relationship

The strong economic ties that have developed between Nepal and India add up to a special relationship that has benefited Nepal and that Nepal has probably taken for granted. Relations between the two countries have been governed by a 1950 Treaty of Peace and Friendship, which was intended to create special relations in the political, economic, and cultural fields. This treaty was the basis for a pact, signed in the early 1960s and periodically renewed, regulating Nepal's trade with and transit right through India and defining a special relationship that provided additional benefits for Nepal. In 1978 the trade and transit pact was separated into two agreements, and the Indians agreed to a year's gap between negotiations for each agreement.

India is under few legal obligations to Nepal. Nepal is not a member of General Agreement on Tariffs and Trade, and India has not ratified either the International Convention on Transit Trade of Landlocked Countries of 1965 or the International Convention on Law of the Sea. Nevertheless, New Delhi accorded special economic privileges to Nepal. The two countries' historical, cultural, and religious ties, as well as security considerations, doubtless provided the impetus for India's action.

An important element in Indo-Nepalese economic relations has been a flourishing smuggling trade, parallel to their official across-border trade, which, although publicly repudiated by both countries, has

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### *The India-Nepal Special Relationship*

*India has extended Nepal several advantages:*

- *India has provided Nepal with 15 routes through Indian territory for Nepal's transit trade with third countries.*
- *India has provided subsidized rates for warehousing and other facilities at major border crossing points.*
- *Nepal has been accorded the preferential supply of essential commodities by New Delhi even when scarcities exist in India.*
- *Goods from Nepal are admitted duty free into India as long as 80 percent of the content is of India-Nepal origin.*
- *India has provided Nepal a revolving credit of more than \$16.5 million annually to help Kathmandu overcome foreign currency shortfalls.*
- *New Delhi has refunded to the Nepalese Government the excise duty on Indian exports to Nepal amounting to approximately \$40 million per year.*
- *Under a complex oil agreement between the two countries' state oil companies, India has refined all of Nepal's imported oil (which India buys for Nepal on the open market in hard currency and then sells to Nepal for rupees).*
- *Under the coal agreement, 1.5 million tons of Indian coal—in short supply in India—have been shipped annually to Nepal.*
- *India has provided Nepal with important income in the form of transfer payments to retired Nepalese Gurkhas.*
- *India provided an outright grant of \$12-14 million in fiscal year 1988-89 for setting up projects in Nepal. New Delhi has budgeted \$14 million for this purpose in 1989-90.*

provided benefits to each. Cheap raw material imports from third countries—not readily available in India—have been illegally shipped across the porous and poorly monitored border into India for immediate sale at profits ranging from 300 to 500 percent. This practice has been tolerated by the two governments because citizens of both countries are involved, and the large profit is being distributed in the economy on both sides of the border. The volume of this business cannot be accurately determined.

The Indian rupees returned to Nepal from such business has contributed significantly to offsetting Nepal's perennial trade deficit with India. This activity is likely to continue, and possibly to increase, in the course of the current crisis.

In addition, food products produced in Nepal's Terai region bordering India have normally moved into India in bulk and then been reexported in smaller quantities to Nepal. Because so many roads go from points in Nepal into India rather than linking points within Nepal, this distribution network will be difficult to replace if the border remains largely closed.

### **Outlook for a New Treaty**

The trade treaty, which provides for renegotiation at five-year intervals, formally expired in April 1988 but was extended for two six-month periods. The transit treaty is valid for seven years.

Nepalese officials believe that by delaying the ratification of a new trade treaty, the Indian Government hopes to force the consolidation of the two treaties and limit the combined agreement to a term of five years. The Nepalese Government wants to extend the period of the transit agreement—considered the more important of the two by Kathmandu—to a term of 10 years.

Under a single treaty, the Indians would be in a position to apply pressure on Nepal on both trade and transit issues on a fairly regular basis. New Delhi wants the two treaties combined, in our view, to stop

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the drift of Nepal's trade away from India. In Nepal's case, separate treaties mean ensuring unimpeded transit and, at the same time, more flexibility to develop new export and import markets. [REDACTED]

India's predominance in Nepal's trade has diminished somewhat in recent years as new export opportunities—in carpets, readymade garments, and handicrafts—and liberalized import policies have resulted in an expansion of trade with third countries. The share of exports to India declined from 68 percent in fiscal year 1983-84 to 37 percent in 1987-88, while exports to the United States went up considerably. The share of Nepal's imports to India declined from 47 percent in 1983-84 to 34 percent in 1987-88. East and Southeast Asian countries have been the main beneficiaries of this shift. In contrast, Nepal accounts for only 1 percent of India's exports and less than 1 percent of India's imports. [REDACTED]

The volume of trade between Nepal and India totaled \$281 million in 1987-88, only slightly higher than the \$259 million in 1986-87 and the \$263 million in 1985-86. Nepal has consistently run a trade deficit with India, although its deficit with third countries, taken together, is larger. [REDACTED]

#### **Petroleum Shortages**

With the breakdown in economic ties, we believe petroleum shortages will be Kathmandu's most serious problem. Nepal has no refinery of its own, and new arrangements to provide finished petroleum products cannot be negotiated on short notice. According to the World Bank, the Nepalese have no more than three to four weeks of fuel stocks—even at current reduced levels of consumption. [REDACTED]

Nepal has been taking steps to deal with its petroleum crisis in the short term. According to [REDACTED] press reporting, Nepal has arranged with China to supply some needed petroleum and Bangladesh has promised to send 1,000 metric tons each of diesel and kerosene. Other alternatives under consideration by [REDACTED]

the Nepalese include contacting major world distributors—for example Exxon or Shell—and obtaining oil from Singapore. [REDACTED]

[REDACTED] Nepalese foreign exchange reserves, estimated at six months' worth of imports in July 1988, are sufficiently strong to allow Nepal to shift purchases elsewhere in the near term. As a precaution, the Nepalese have set up a coupon rationing system to distribute petroleum and diesel fuel for vehicles. In addition, Nepalese authorities have cut electric rates and fuelwood prices by 25 percent to lighten the burden on consumers. [REDACTED]

Nonetheless, Nepal's outlook for fuel supplies is not good in the short term. Switching to new sources does not do much good if these supplies cannot get through. New Delhi is capable of imposing administrative hurdles that could clog transit points, making the movement of goods slow and expensive. Furthermore, third-country fuel sources are problematic because of the time lag between ordering and arrival and the inadequate storage facilities in Nepal. Getting petroleum products from China is unrealistic because of the prohibitive costs, difficult transportation routes—the road from Tibet to Nepal is often blocked by landslides—and limited Chinese supplies. [REDACTED]

The unavailability of household fuel could have a far-reaching impact on Nepal's environment. Pressure on already depleted forests for fuelwood to replace imported home fuels may negate the progress that has been made through expensive reforestation projects. The fragile hill areas of Nepal will be most affected. [REDACTED]

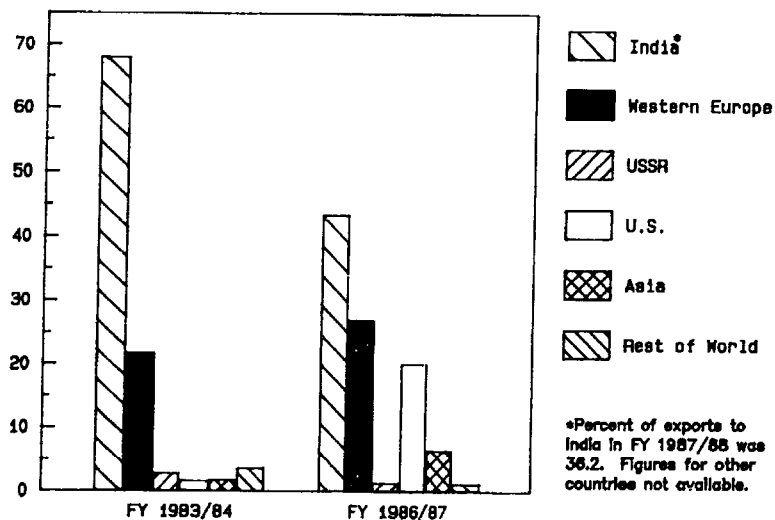
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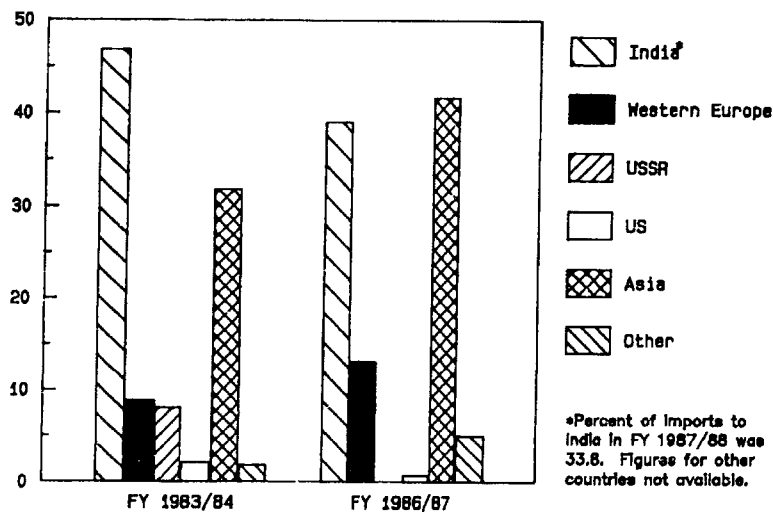
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# NEPAL: DIRECTION OF TRADE Percent of Total

Exports, f.o.b.



Imports, c.i.f.



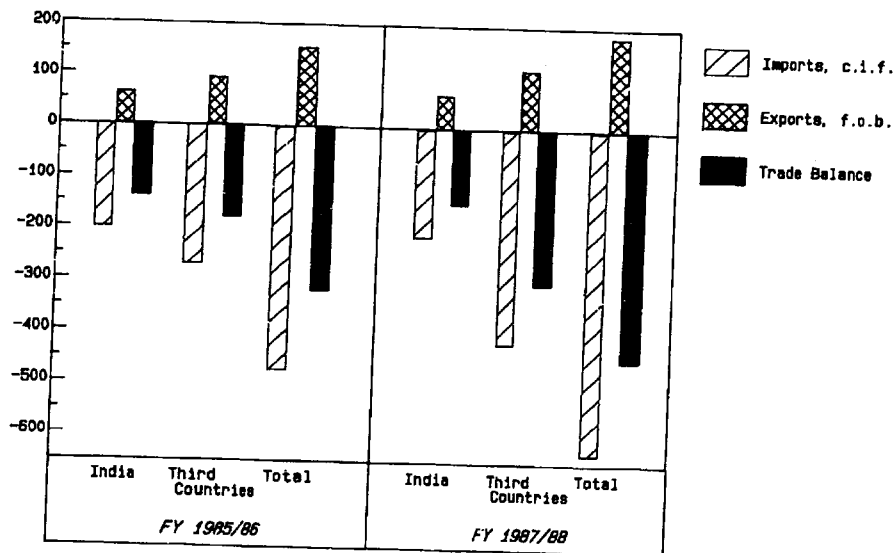
Source: World Bank, Nepalese authorities

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### NEPAL: TRADE BALANCE BY AREA FY 1985/86 - FY 1987/88

US dollars in millions\*



Source: World Bank

\*Nepali rupee/US \$: 1985/86, 19.8; 1987/88, 22.1

#### Other Effects

Because so many aspects of the Nepalese economy depend on Indian supplies and markets, Nepal will experience other difficulties if satisfactory new trade and transit agreements with India are not concluded:

- New tariff barriers will be erected on Nepalese products. For example, agricultural goods from the Terai region that are shipped to India will face tariffs of up to 150 percent, making these goods uncompetitive in Indian markets.
- As shortages develop, heightened inflationary pressures could lead to a devaluation of the Nepalese rupee, and this would damage exports, banking, and tourism.
- A flight of capital could develop, further threatening Nepal's economic stability. A run on savings could easily be fueled by the political situation or by even the rumor of the failure of one of Nepal's major banks. Nepal is especially susceptible to capital flight because a large percentage of the country's savings belongs to relatively few individuals or families—most of whom have interests in India and could transfer funds immediately—and because there are relatively few banking institutions in Nepal.

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- The lack of Indian supplies has already largely shut down the garment industry, the backbone of Nepal's efforts to develop third-country export markets, and more businesses are expected to be crippled in the next few weeks as inventories are exhausted.
- For the long term, the transit issue will be the most important. Goods imported by Nepal, regardless of their source, have to come through Calcutta. The fact that the Indians have allowed only two border points to remain open will drive up the costs of these imports over time because of the greater distances that must be traveled.
- The recent strides made by Nepal to attract foreign investment, especially in tourism, will be hurt. The government's incentives for private investment will not have much effect as long as problems with India remain unresolved.
- Development projects funded by multilateral development banks and major bilateral donors will grind to a halt because of difficulties in getting personnel and materials to the project areas.

#### Can Nepal Hold Out?

The economic pressures will not allow Nepal to hold out for long. Inflationary pressures will quickly become acute in Kathmandu, a city of civil servants on fixed salaries. Pressure on the government to reach an agreement with India will be strong from both outside and inside the government. As the welfare of government workers is threatened, we believe government ministries will suffer a further decline in efficiency and may even collapse.

In contrast, Nepal's hill and mountain areas, and the agrarian sector in general, would be least affected because they depend less on trade with India.

Furthermore, the more developed and affluent Terai region—which in many respects already has more in common with India than with Kathmandu and the hill peoples of Nepal—is likely to increase ties to India. Cross-border smuggling may also increase, with goods entering Nepal from India rather than the other way around.

The government is also concerned with internal unrest. In early April student demonstrations protesting shortages of essential commodities occurred in Kathmandu. Although the protests were quickly put down, Nepalese officials believe more demonstrations may occur if the fuel crisis is not adequately addressed.

#### Implications

Nepal cannot escape the fact that it is a landlocked country whose economy rests in large part on access through India. Deterioration in relations with India could result in a situation that could completely disrupt the Nepalese economy. If that happens, the monarchy could be threatened.

We believe Nepal ultimately will negotiate a new trade treaty that will be less advantageous than what Nepal enjoyed earlier. This will hurt Nepal economically, but Kathmandu appears willing to give up those advantages to demonstrate its sovereignty and independence. How successful Kathmandu is in formulating a new economic relationship with India will largely depend on what is worked out in the way of a transit regime.

Nepal will probably need to request increased assistance from its bilateral and multilateral donors. About half of its foreign aid comes from multilateral development banks, and Nepal will probably request an increase. It may ask the United States and other major contributors to these banks to intercede on its behalf. The World Bank, through its soft loan window, has contributed heavily to Nepal's long-term development efforts, which have been slow to get off the ground.

The imbroglio with India will do much to reverse recent economic achievements in Nepal. In recent years the government has launched three major initiatives—the Seventh Plan, the Structural Adjustment Program, and the Basic Needs Program—to reorient policies and institutions, to accelerate growth, and to meet basic needs. If the pace of reforms is not maintained, this period may be viewed as yet another lost opportunity.

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## Nepal: Resisting the Forces of Change

Nepal remains virtually an absolute monarchy, despite some liberalizing steps by King Birendra over the past decade to create the appearance of a more representative government. After over three decades of exposure to outside influences, Nepal is still largely a feudalistic society where change is slow and progressive forces are divided and weak. King Birendra's control has been enhanced by the absence of strong political opposition. Political parties are officially banned in Nepal. The monarchy established a national legislature, the Rastriya Panchayat, in the early 1960s to give the impression of representative government, but it is essentially powerless and subject to the King's direction.

Political activists—including students and members of the officially banned Congress and Communist parties—will continue to press for reforms, and they may use the current impasse between Nepal and India over trade and transit issues to push for more popular participation role in government. Protests over the lack of representative government have erupted in the past, and some have brought about moderate reforms. Even so, we see little likelihood such activists will spark enough unrest or be able to acquire sufficient support to overthrow the monarchy.

To counter popular moves for reform as the country prepares for the next National Legislature Election in 1991, Birendra may initiate some reforms next year to increase popular representation. His recent hardline speeches in defense of the nonparty system suggest he will try to avoid taking steps that would seriously challenge royal control.

### The Monarchy: Holding on to Power

The King is the most powerful political force in Nepal, and the monarchy is the most significant political institution. The legitimacy of the monarchy is deeply rooted in Nepal's history and religion, and Birendra plays a critical unifying and stabilizing role as a guarantor of Nepalese sovereignty. Religious values bind the King and his people. Much of Birendra's power lies in the acceptance by Nepal's large Hindu majority that he is a reincarnation of the

### King Birendra

*King Birendra Bir Bikram Shah Dev, 43, is the sole source of authority for all government actions. He is the ultimate decisionmaker on foreign and domestic policy matters. His powers are virtually absolute.*

god Vishnu—an ancient tradition reserved for Nepalese kings. Academics report that Birendra's power also rests on his ability to retain the support of key groups in a scattered, locally isolated, and multiethnic population. He relies heavily on the influence of elite families that possess high hereditary status, large landholdings, or commercial wealth and who see reforms as a threat.

The monarchy has not always exercised supreme power in Nepal. Nepalese kings were figureheads for over a century while the country was ruled in isolation from the world by a family of hereditary prime ministers, the Ranas. King Birendra's grandfather, in alliance with progressive politicians and with Indian support, regained control of the government in 1951.

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The monarchy relinquished power in 1959 when Nepal began a brief experiment with parliamentary democracy, in keeping with a commitment the monarchy had made when it reassumed power eight years earlier. The Congress Party, a democratic socialist party influenced by India, easily won a large majority of the seats in the new parliament, and its leader became prime minister. [REDACTED]

Within a year King Mahendra, Birendra's father, chafed at his unaccustomed constitutional role. He dissolved the parliament, charging the experiment had failed because of party infighting, jailed many Congress Party leaders, and banned all political parties. He replaced the parliamentary system with what is known as the "partyless democracy"—a tier of four councils, or panchayats, beginning at the national level and extending down to the village level, the members of which cannot represent political parties. Upon his assumption of power in 1972, King Birendra chose to maintain the same institutional framework. [REDACTED]

**The Rastriya Panchayat: A Rubberstamp Legislature**  
Birendra views nonparty democracy as essential to the maintenance of Nepal's stability, [REDACTED] increasing the significance of the legislative assembly as both his gesture to representative government and his limit on participatory political institutions. An assembly of 140 members elected for a five-year term that meets only three months a year, the Rastriya Panchayat offers symbolic but essentially powerless participation in the country's political life. The [REDACTED] critics of the panchayat system describe the national legislature as a debating society, with the palace making the real decisions. Although panchayat democracy gives the impression of endorsing popular sovereignty, it is almost totally subservient to the palace, and we believe the monarchy will continue to keep it on a short leash. [REDACTED]

The legislative election scheduled for 1991 is likely to heighten popular interest in greater participation in the government. During the 1981 and 1986 national elections, members of liberal and leftist sentiment and from more varied class backgrounds were elected. We expect similar results in 1991. [REDACTED]

[REDACTED] the current legislative reflects generational and ideological divisions, and the next one probably will be even more likely to reflect political and social differences. [REDACTED]

Even if the King initiates some political reforms before the 1991 election, we believe he will not grant the legislature sufficient power to challenge his authority. In a speech last December at Nepal's Constitution Day celebration, Birendra praised the panchayat system, [REDACTED] as democratic and necessary for stability. Moreover, in our view, the King's deep suspicion that a system involving freely contesting political parties would create openings for interference by outside powers—such as India, the Soviet Union, China, or Western nations—will strengthen his resolve to maintain royal control. [REDACTED]

#### **Political Parties: Ineffective Challengers**

Political parties are officially banned in Nepal, but the monarchy does tolerate some low-level party activity. Disunity and weak leadership among the parties, along with their limited popular support, leave the monarchy free to ignore their demands for political reform. The largest moderate opposition group is the Congress Party, while the factionalized Communist Party comes closest to rivaling the Congress Party. [REDACTED]

**The Congress Party.** The Congress Party, which might provide a means of stable political change, has few options other than to wait for the 1991 national election while trying to contain factionalism within its ranks. The party lacks the power to press Birendra to take steps to increase representative government in Nepal. [REDACTED]

Although some members argue that their public differences prove how democratic the party is, [REDACTED] personality and ideological disputes have increased party weaknesses, with members in the lower ranks generally dispirited. We believe none of the current leader has the ability to strengthen the party. [REDACTED]

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### *Rastriya Panchayat*

*The Rastriya Panchayat is a nonparty unicameral national legislature charged with developing and passing legislation, appropriating government funds, and overseeing the day-to-day administration of the government. As the only body directly elected by universal adult suffrage, the legislature is an important symbol of democracy in Nepal. The palace, however, makes all real decisions and closely watches the legislature to ensure that it does not counter palace wishes. The legislature is largely restricted to domestic affairs and proscribed from interfering in palace activities, foreign affairs, and other broad policy areas, which are the province of the King and his advisers. All legislation passed by the assembly must be approved by the King before it becomes law. Criticism of the monarchy and Constitution is not allowed.*

*The legislature consists of 140 members, of which 112 are popularly elected and 28 appointed directly by the King. A member serves a five-year term and must be a Nepalese citizen over 25 and a member of one of the six government-sanctioned organizations of important social groups—youth, elders, peasants, women, ex-servicemen, and workers—that are intended to fill the role of the banned political parties. The legislature elects from among its members a prime minister, who must win at least 60 percent support, and a chairman, both with final*

*approval by the King. The prime minister, in turn, selects the Cabinet Ministers, who must also have royal approval. The legislature's steering committee advises the chairman on the proper conduct of business before the legislature and its five functional committees, which deal with finance, social affairs, development, water resources, and legislative affairs. The legislature is normally in session only three months a year.*

*The Rastriya Panchayat is part of the four-tier panchayat system—village and town, district, zone, and national—created in 1962 by Birendra's father, King Mahendra, to provide popular participation in government under royal tutelage. It is based on the village council gatherings that are part of the country's traditional political structure. In a national referendum held in May 1980 to choose the country's future political system, 55 percent of the voters reaffirmed the nonparty system. The King subsequently amended the Constitution to allow the direct election of members of the Rastriya Panchayat, its nomination of a single candidate for the prime ministership, and its oversight of the Council of Ministers.*

The Congress Party boycotted the national elections in 1981 and 1986, a decision that resulted in strengthening the panchayat system and the leftists who participated. In 1987 the party reconsidered its position and allowed its members to run in local elections as independent candidates. Party members won some important urban seats, but generally were unsuccessful because of poor campaign tactics and weak organization. party leaders continue to argue over the 1987 decision to participate. More moderate party members believe participation was a necessary step back from relative oblivion, while purists see it as a

mistaken violation of party principles. If more party members decide to run as independents and can gain seats in the National Legislature, more effective representative government might evolve.

Some party leaders are looking to tactical cooperation with Nepal's leftist elements, primarily factions of the Communist Party. those who advocate such a position believe an alliance is the only way to give groups outside the system sufficient

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strength to challenge it and force a change. Other leaders believe such a relationship will further weaken and discredit the party. The Congress and Communist parties issued a joint statement early this year demanding a lifting of the ban on political parties. We believe ideological differences will keep the two sides from extending their cooperation beyond token exchanges of support. Congress Party involvement with the Communists probably would further split the moderates. [REDACTED]

*The Communist Party.* We believe that the Communist Party's pro-Soviet and pro-Chinese factions, despite recent gains, are incapable of establishing themselves as an influential factor in Nepalese politics. Because of disunity and shifts in alliances, the party has failed to mold its main supporters—unemployed youth and university students—into a significant political force. We believe the Nepalese Government will continue to keep the Communists in check. [REDACTED]

likely will continue to see his near absolute power as inherent under the Hindu religion and to believe he must retain it to carry out the programs he envisions for the development of Nepal—at his pace—as well as to maintain Nepal's sovereignty against external meddling. [REDACTED]

[REDACTED]

Without additional reforms, Birendra risks binding himself and the monarchy to the fate of the nonparty panchayat system. His unspoken conviction that the political parties would sell out Nepal's interests to the Indians, in the case of the Congress Party, or to the Soviets, in the case of the Communist groups, has discouraged trends toward meaningful political change and stigmatized the more moderate political activists as unworthy of being trusted with the nation's future. [REDACTED]

[REDACTED]

Birendra may miscalculate the amount of time he has to implement change at his pace. If he ignores the popular undercurrent in favor of a more representative system and undercuts the moderates favoring democratic change, there is a danger that he may strengthen the more radical elements. If the moderates grow impatient, more of them may decide to increase cooperation with the leftists while hoping to prevent the radicals from attaining their goal of overthrowing the monarchy. The possibility also exists that over time more Nepalese may conclude that the moderates have been ineffective in bringing about reforms and turn their support to the radicals [REDACTED]

[REDACTED]

#### **Outlook: Not Yet at a Crossroads**

We believe Birendra has no intention of voluntarily surrendering real power to moderate opposition elements, and the monarchy has not come under sufficient domestic pressure to change its position. The current economic impasse between Nepal and India has heightened the opposition's criticism of the King, but not enough, in our judgment, to force him to take radical steps toward reform. Birendra more

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